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BEFORE THE ARIZONA CORPORATION COMMISSION

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COMMISSIONERS
GARY PIERCE, Chairman
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AZ CORP COMMISSION
DOCKET CONTROL

IN THE MATTER OF THE
APPLICATION OF ARIZONA PUBLIC
SERVICE COMPANY FOR
AUTHORIZATION FOR THE
PURCHASE OF GENERATING ASSETS
FROM SOUTHERN CALIFORNIA
EDISON AND FOR AN ACCOUNTING
ORDER.

DOCKET NO. E-01345A-10-0474

Arizona Corporation Commission

DOCKETED

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INITIAL POST-HEARING BRIEF
OF
ARIZONA PUBLIC SERVICE COMPANY

September 30, 2011

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1 **I. INTRODUCTION**

2 *The proposed transaction "is an opportunity that arose by accident, I would say.*
3 *By the gift of California to the citizens of Arizona, it looks like to me. And I think*
4 *that we would be remiss in not taking advantage of that."*

5 - Dr. Thomas Fish, on behalf of the Residential Utility Consumers Office
6 (Hearing Transcript at 580).¹

7 In its Application, Arizona Public Service Company ("APS" or "Company") seeks
8 the Arizona Corporation Commission's ("Commission") authorization of and support for
9 the purchase of Southern California Edison's ("SCE") 48% ownership interest in Units 4
10 and 5 of Four Corners Power Plant ("Four Corners"). If that transaction is consummated,
11 that 48% interest, on top of APS's existing 15% share of those Units, would bring APS's
12 total ownership interest in Units 4 and 5 to 63% -739 megawatts ("MW") of coal capacity
13 above what APS currently owns. If the transaction moves forward, APS will retire Four
14 Corners Units 1 through 3, significantly smaller, older, and less efficient units (totaling 560
15 MW) that are fully owned by APS.

16 The Company's proposal is not based just on customer cost considerations, although
17 the evidence demonstrates that the proposed transaction is a strikingly good deal, saving
18 APS customers at least \$500 million in present value revenue requirements. It is not just
19 about what is good for the Navajo Nation, although no party disputes that the proposed
20 transaction would save the Navajo community, already subject to high unemployment rates,
21 from what the Navajo have described as "cataclysmic" economic consequences.² Nor is it
22 just about the environment, although the environmental benefits of closing three coal units
23 and installing pollution control equipment on two others are significant and uncontroverted.
24 Rather, the proposed transaction seeks to balance all of these interests in a solution to the
25 several challenges facing Four Corners that serves the broad public interest.

26
27 ¹ References to the hearing transcript will hereafter be cited as "Witness Testimony, Tr. at page number."

28 ² See March 1, 2010 letter from President Dr. Joe Shirley of the Navajo Nation to Dr. Anita Lee of the EPA,
attached to APS Exhibit 11, Attachment MAS-1.

1 **A. *The APS Proposal is Good for Customers.***

2 **1. The purchase price is a striking value for customers.**

3 Evidence at hearing left little doubt that the proposed transaction is a remarkable deal
4 that will potentially save APS customers upwards of \$500 million in net present value
5 revenue requirements, if not more, compared to the reasonable alternatives. Among the
6 parties who took time to assess the transaction's economic value, the only dispute was not
7 *whether* the asset purchase is a good deal, but just *how good* a deal it is.

8 APS Witness Patrick Dinkel testified that APS's proposed transaction saves
9 customers \$488 million compared to a combined cycle alternative on a net present value
10 revenue requirement basis. *See* APS Exhibit 8 at 7, 10. This almost \$500 million savings is
11 net of both the purchase price and the capital and O&M costs for all future environmental
12 controls expected to be required for the plant.³ *See* Hearing Testimony of Mark Schiavoni
13 ("Schiavoni Testimony"), Tr. at 245-46; Hearing Testimony of Patrick Dinkel ("Dinkel
14 Testimony"), Tr. at 540.

15 Dr. Thomas Fish on behalf of the Residential Utility Consumer Office ("RUCO"),
16 who critically examined APS's analysis, testified multiple times that "in [his] opinion, no
17 one could reasonably envision situations where the company's requested alternative is not
18 best." Hearing Testimony of Dr. Thomas Fish ("Fish Testimony") Tr. at 580-83.
19 Commission Staff Witness Margaret Little similarly reviewed APS's assumptions and
20 analysis, found them to be reasonable, and concluded that APS's proposal is economically
21 the best of the alternatives. *See* Hearing Testimony of Staff Witness Margaret Little ("Little
22 Testimony") Tr. at 570, 575.

23 Western Resource Advocate ("WRA") witness Dr. David Berry conducted his own
24 independent economic analysis of the Company's proposed transaction. *See* WRA Exhibit

25 _____
26 ³ The environmental costs considered in the APS revenue requirement analysis include those required to
27 comply with the Clean Air Act's regional haze requirement ("Best Available Retrofit Technology") which
28 APS assumed to be Selective Catalytic Reduction, the Clean Air Act's mercury emission requirements
("Maximum Achievable Control Technologies"), coal ash handling related to the Resource Conservation
Recovery Act (also referred to as "coal combustion residuals"), and potential carbon dioxide emission costs
that may arise upon the passage of a federal Clean Air Act. (*See* Schiavoni Testimony Tr. at 245-246.)

1 1; Hearing Testimony of Dr. David Berry ("Berry Testimony"), Tr. at 915. Like APS, Dr.
2 Berry concluded that the cost of the APS proposal was "by far the lowest cost of the options
3 available over a wide range of reasonable assumptions." Berry Testimony, Tr. at 915.

4 Judah Rose, the Managing Director of ICF International and an expert in power plant
5 valuation, both reviewed the integrity of the APS analysis and conducted an independent
6 analysis of the transaction's value, using his own data in part and his firm's respected
7 valuation model (the same model used by the Environmental Protection Agency for
8 economic evaluation purposes). See APS Exhibit 10 at 1, 3. His analysis revealed that, far
9 from being too high, APS's \$500 million anticipated revenue requirement savings was on
10 the conservative side. In Mr. Rose's expert opinion, SCE's interest in the Four Corners
11 plant compared to a natural gas alternative is worth almost one billion dollars, for which
12 APS has to pay only \$294 million. See Hearing Testimony of Judah Rose ("Rose
13 Testimony"), Tr. at 182. The net result is a cost savings to customers of \$712 million net
14 present value— a 300% savings beyond both the purchase price and the cost of all
15 reasonably anticipated future environmental controls. See Rose Testimony, Tr. at 154-55,
16 182, 211-212. As Mr. Rose testified, the contract price that APS negotiated for SCE's
17 interest in Units 4 and 5 is "one-tenth the cost of replacement of a new coal-powered plant,"
18 making the proposed transaction "an extraordinary opportunity for the citizens and the
19 ratepayers, customers of APS to save money." Rose Testimony, Tr. at 138, 180-181.

20 Mr. Rose's valuation of the proposed transaction's economic benefit is 22% higher
21 than that of APS. See Rose Testimony, Tr. at 152. The primary reason for this difference is
22 that, in Mr. Rose's opinion, APS's analysis used conservative assumptions about natural gas
23 prices and carbon costs, which combination results in a lower revenue requirement savings
24 compared to a gas alternative than might actually occur. As Mr. Rose explained, the value
25 of the proposed transaction is heavily influenced by the difference between coal and gas
26 prices. See Rose Testimony at Tr. 181. The higher the assumed coal price (*i.e.*, the higher
27 the assumed carbon price) and the lower the assumed natural gas price, the more biased the
28

1 analysis will be *against* the proposed transaction and in favor of a natural gas alternative. In
2 this case, APS's analysis assumed a \$20/ton carbon price beginning in 2013 and escalating
3 at 2.5% each successive year. *See* APS Exhibit 8 at 10. While this assumption made sense
4 in 2010 when APS conducted analysis, current events have made clear that there is no
5 likelihood that any carbon price will be imposed on a national level in 2013, and that such
6 regulations typically require a five-year lead time. *See* Rose Testimony, Tr. at 143, 225.
7 APS witnesses confirmed that the carbon assumptions used in the Company's revenue
8 requirement analysis "are on the extreme from a market perspective" and that, rather than
9 assuming \$20/ton beginning in 2013, one might now reasonably assume a fraction of that in
10 2015 or 2017, perhaps as far out as 2020. *See* Dinkel Testimony, Tr. at 512.

11 In addition, the gas forecast used in APS's revenue requirement analysis is
12 conservative compared to current forward-looking market prices for natural gas. *See* Rose
13 Testimony, Tr. at 150; Dinkel Testimony, Tr. at 512. Indeed, the evidence is undisputed
14 that gas prices have risen since APS conducted its analysis in 2010 and that they are
15 expected to continue to rise in the future, notwithstanding the discovery of shale gas
16 reserves. *See* Rose Testimony, Tr. at 144, 150, 152, 181-82, 221-22 ("The best information
17 available indicates that gas prices are at a low point. They're not sustainable at current
18 levels."); Hearing Testimony of David Schlissel ("Schlissel Testimony"), Tr. at 61-62, 91;
19 Berry Testimony, Tr. at 923; Dinkel Testimony, Tr. at 401; Hearing Testimony of Greg
20 Patterson ("Patterson Testimony"), Tr. at 991. As Mr. Rose testified, "our analysis
21 indicates that gas prices are at a historical low, and this is a buy low, sell high opportunity
22 that the Commission is being asked to make a decision on." Rose Testimony, Tr. at 181.
23 According to Mr. Rose, APS's conservative use of low natural gas prices and high carbon
24 cost assumptions only highlights the value of the transaction for APS customers – if gas
25 costs rise and/or carbon prices are pushed out or fall below the assumed level, customers
26 will save that much more money.

1 Only two parties took issue with the Company's economic analysis: the Sierra Club
2 and the Arizona Competitive Power Alliance ("ACPA"). Neither the ACPA nor the Sierra
3 Club took the time to conduct a review of APS's revenue requirement analysis or offered
4 any counter-analysis to refute any of the three independent net present value revenue
5 requirement savings analyses in the record, each of which showed a remarkable benefit to
6 customers. Rather, they posited that "more evidence is needed" to confirm these analyses.
7 That, however, is simply not the case.

8 For example, ACPA and, to a lesser extent, the Sierra Club, suggested that APS
9 *might* be able to purchase a combined cycle gas plant for a lower price than what APS
10 assumed in its analysis, and that APS should thus be required to issue a Request for
11 Proposals ("RFP") to gather additional data about the going market price for such facilities.
12 *See, e.g.,* Patterson Testimony, Tr. at 952-953. Putting aside momentarily the policy
13 reasons for why using an RFP for the purpose of data gathering is a bad idea (described
14 *supra* at Section IV.A), the undisputed evidence shows that such an effort would be
15 fruitless.

16 The lowest cost for a combined cycle plant noted in the record was \$400/kW for the
17 "Entegra plant," a figure introduced for the first time on the stand without any evidentiary
18 support by a witness who readily admits to "being one of the few people in the room who
19 has absolutely no knowledge of what things [power plants] go for price-wise." Patterson
20 Testimony, Tr. at 988, 996-997. That unsubstantiated \$400/kW value is materially less than
21 the \$553/kW - \$600/kW to as high as \$900/kW combined cycle cost range offered by Judah
22 Rose for reported transactions completed in the Desert Southwest in 2011. *See* APS
23 Exhibit 10 at 23. One of those transactions—for the Gila River combined cycle plant in
24 Arizona—is owned by Entegra and is likely the Entegra deal to which Mr. Patterson referred.
25 *See* Rose Testimony, Tr. at 174. *See also* www.entegrapower.com (Entegra public website
26 identifying Entegra as the owner of the Gila River facility).⁴ Unlike Mr. Patterson, Mr.

27 _____
28 ⁴ Pursuant to Rule R14-3-109(T), APS requests that the Administrative Law Judge take official notice of this publicly available website.

1 Rose is an expert in power plant valuation, who diligently researched “all of the transactions
2 . . . in the United States in the deregulated power industry” during his evaluation of the
3 proposed transaction. Rose Testimony, Tr. at 172-73. The right figure for the Entegra/Gila
4 River transaction is thus not likely to be Mr. Patterson’s \$400/kW, but somewhere in Mr.
5 Rose’s informed \$550 to \$600 per kW range.

6 Even assuming that APS could somehow acquire an existing combined cycle plant
7 for \$400/kW or even lower, and leaving aside questions about whether such a plant would
8 require new transmission to bring the generation to APS’s load pocket in 2017 when the
9 need arises (thereby increasing its cost),⁵ the record makes clear that a \$400/kW combined
10 cycle cost *still* cannot beat the economic value of the proposed transaction. Indeed, a
11 \$400/kW combined cycle transaction price is also significantly higher than the “breakeven”
12 price identified by Mr. Rose in his testimony, which is stunningly low. *See* APS Exhibit 9
13 at 23. As Mr. Rose testified, his expert analysis and valuation model “indicate that
14 essentially you would have to give away your power plants or offer them at a price that’s a
15 fraction of any reasonable expectation,” “well below any recorded price in the history of the
16 industry,” to beat the Four Corners purchase price. *See* Rose Testimony, Tr. at 138, 172.
17 An RFP or any other process intended to gather additional data in this regard thus “would
18 fail to be probative.” *Id.* Simply put, no other evidence is needed to know that the
19 proposed transaction is a good deal for customers.

20 To the limited extent that the Sierra Club’s witness (a longtime member of the Sierra
21 Club who has testified on its behalf 20 times since just 2007)⁶ reviewed APS’s economic
22 analyses and attempted to critique it: (1) he focused almost exclusively on APS’s levelized
23 cost analysis, taking no issue with APS’s more comprehensive revenue requirement

24 ⁵ As Mr. Dinkel testified, if this transaction is not consummated, APS’s need for baseload energy does not
25 arise until 2017. Dinkel Testimony, Tr. at 510. The evidence also made clear that all existing combined
26 cycle generation is located in the Palo Verde area, and APS will have no transmission capacity available in
27 2016 to deliver generation from such a plant to its load pocket. *See* Dinkel Testimony, Tr. at 503. Adding
28 assets to the Company’s generation fleet without knowing that those resources will have transmission
available to deliver the energy to customers when needed creates a reliability risk – one that the Company
should not be required to take. *Id.* at 504.

⁶ *See* Schlissel Testimony, Tr. at 31.

1 analysis, which serves as the basis for APS's customer savings value⁷, *see* SC Exhibit 2 at
2 16-24; and (2) he admitted on cross examination that the testimony offered in attempt to
3 undermine APS's levelized cost analysis was based on calculations that contained fatal
4 errors, the correction of which ultimately supports the Company's analysis, *see* Schlissel
5 Testimony, Tr. at 66.

6 Moreover, notwithstanding the economic flavor of the Sierra Club's testimony, the
7 strong weight of the evidence suggests that the Sierra Club's position in this docket is not a
8 matter of economics, but of ideology. The record makes clear that the Sierra Club seeks to
9 shut down Four Corners irrespective of the economic impact to APS customers or, for that
10 matter, the Navajo community. There was no dispute that, as part of its "Beyond Coal
11 Campaign," the Sierra Club's goal is to "phase out" existing coal fired plants, and
12 specifically targets Four Corners as one of the plants to be extinguished as part of that
13 campaign. *See* APS Exhibit 1 and 2 (excerpts from the Sierra Club website describing the
14 "Beyond Coal" campaign and tagging the Four Corners Power Plant with a skull and cross-
15 bones to identify the plant as an "old, dirty way of generating power" that its members
16 might help "phase out"). In this case, that goal is accomplished by either (1) demonstrating
17 that the deal is not beneficial for APS customers (which the Sierra Club did not do, as
18 described above), or (2) distracting the Commission with the specter of "other alternatives"
19 that might be explored – the economics of none of which the Sierra Club actually analyzed,
20 *see* Schlissel Testimony, Tr. at 33-34, and none of which, the evidence made clear, make
21 any economic or operational sense.⁸ The vast majority of the Sierra Club's testimony takes
22 the latter approach, pointing APS down a series of rabbit trails in a deliberate stall tactic
23 calculated to ultimately force Four Corners to suffer the same fate as the Mohave Power
24 Plant – a plant that faced many of the same challenges Four Corners now faces and that
25 suffered a forced shutdown in 2005 because time simply ran out to find solutions to the

26 ⁷ For a discussion of why a present value revenue requirement analysis is the most accurate way to evaluate
27 the merits of the proposed transaction, *see* APS Exhibit 13 (Pat Dinkel Rebuttal Testimony) at 6-7.

28 ⁸ *See, e.g.*, APS Exhibits 9 (confidential) and 10 (public) at 23-25; APS Exhibit 12 at 7-11; Rose Testimony,
Tr. at 136-138, 189, 191-92.

1 problems that ultimately led to its demise. *See, e.g.,* Schiavoni Testimony, Tr. at 351.
2 Notably, the Sierra Club's efforts in the Mohave proceeding contributed to the delay that
3 ultimately forced the plant to shutdown. *See* APS Exhibit 10 at 5-6.

4 There is thus no evidence that credibly disputes that the Company's proposed
5 transaction will save customers at least half a billion dollars in revenue requirements on a
6 net present value basis, if not more. The strong weight of the evidence thus confirms that
7 "the cost minimizing action is to purchase these plants expeditiously" because the
8 transaction is, simply put, a "great deal." Rose Testimony, Tr. at 230.

9 **2. The APS Proposal Preserves APS Customers' Existing Interest in**
10 **a Reliable Generation Asset.**

11 Not only is the purchase price of APS's intended additional investment in Units 4
12 and 5 highly cost-effective compared to the alternatives, the purchase will also preserve
13 APS's existing 15% interest in those units. *See* Hearing Testimony of Jeff Guldner
14 ("Guldner Testimony"), Tr. at 658. Preserving that interest will allow APS customers to
15 continue to benefit from the cheap energy produced by an asset for which they have been
16 paying since around 1969-70, when Units 4 and 5 were placed in service. *See* APS Exhibit
17 11 at 2. The evidence is undisputed that Four Corners Units 4 and 5 are substantially
18 depreciated, *see* Schiavoni Testimony, Tr. at 323, and that an interest in an almost fully
19 depreciated coal plant is "the cheapest asset you can essentially get," *see* Patterson
20 Testimony, Tr. at 1016. In fact, the Company's interest in preserving its existing ownership
21 of Units 4 and 5 was the primary driver behind APS's decision to take SCE up on its
22 purchase offer. As Mr. Dinkel testified, "APS is entering this decision from trying to
23 preserve an economically and operationally advantageous position with our coal fleet. So
24 we started this process with, how do we protect our interests in our Four Corners assets that
25 the customers have substantially paid for and serve our customers well?" Dinkel
26 Testimony, Tr. at 385; *see also* Guldner Testimony, Tr. at 658.

27 There is no real dispute that the Company's existing interest in Four Corners Units 4
28 and 5 is at risk of loss and in need of preservation. As the evidence demonstrated, SCE has

1 informed the joint participants in Units 4 and 5 that California regulations and California
2 Public Utilities Commission rulings prevent it from making any "life extending"
3 investments in the plant beginning in 2012. See APS Exhibit 11 at 5. Citing those
4 regulations, SCE informed its co-owners at the end of 2009 that it will not pay its 48%
5 share of any of the environmental controls required by the Environmental Protection
6 Agency ("EPA") to be operational on Units 4 and 5 (investments that begin as early as
7 2012), and that it will pull out from the plant entirely by 2016. *Id.* at 5-6; APS Exhibit 16.
8 There was no dispute that operating a jointly-owned power plant when uncertainty exists
9 about who will pay for 48% of the hundreds of millions of dollars worth of environmental
10 controls required within the next few years would be a challenge. See, e.g., Schlissel
11 Testimony, Tr. at 42. Unless someone assumes SCE's share, there is a strong risk that the
12 plant will close. See, e.g., Rose Testimony, Tr. at 177; Schlissel Testimony, Tr. at 34-35;
13 Fish Testimony, Tr. at 586 and 592.

14 The evidence also made clear that APS is quite probably the only entity that can
15 reasonably step into SCE's ownership position. No third-party buyer is likely to come
16 forward. First, SCE has informed APS and the other co-owners that it does not intend to
17 locate a third-party buyer for its interest and that, if none of the existing participants chose
18 to purchase it, the participants "should be looking at making arrangements for a logical
19 shutdown of Units 4 and 5 starting in 2014." Schiavoni Testimony, Tr. at 289. Second,
20 even if SCE decided to look for a third-party buyer, several complicating factors at the plant
21 would likely deter such a buyer from stepping into SCE's ownership position. As Mr. Rose
22 testified:

23 There aren't many power plants in the United States that are owned
24 by six entities. Generally someone owns it, you call them up, and you
25 do the due diligence, and boom, you do the transaction. You don't
26 have four states that are regulating it. You don't have to deal with the
27 right of first refusal. You don't have to deal with the very unique
28 characteristics of a co-tenancy agreement, a land lease. You don't
have to necessarily become an expert and do the due diligence on the
coal mine because the plants are all on railroads or barges. You don't
have to go through the details of a lot of complex agreements and
regulatory requirements that are unique to this situation.

1 Rose Testimony, Tr. at 214-15. Neither does it appear that any of the existing owners are
2 inclined to purchase the SCE share under current circumstances. The right of first refusal
3 with respect to the APS/SCE Asset Purchase Agreement expired in March of 2011 with no
4 takers—a fact that is likely due to the heavier amount of coal in those utilities’ resource
5 portfolios. *See* Rose Testimony, Tr. at 166.

6 For various reasons, APS is singularly situated to purchase SCE’s majority interest.
7 Because APS wholly-owns Four Corners Units 1-3, APS alone has the opportunity to close
8 three of Four Corners’ five existing units and enable the installation of environmental
9 controls at the remaining two so as to better work with the EPA and improve the plant’s
10 environmental footprint. *See* Guldner Testimony, Tr. at 656. Moreover, as the Operating
11 Agent for the plant, APS is also best positioned to work through the numerous complexities
12 the plant faces in a way that will best maximize the asset’s value. *See id.* As RUCO
13 witness Dr. Fish explained, “APS has more value from that plant, my estimation, than
14 almost anybody else. APS has the transmission facilities for it. APS has the customer base
15 for it. APS has good use for the energy, and they can use that energy directly. APS has
16 operated that plant. They are knowledgeable of it. They know how to run it and how to run
17 it efficiently. Nobody else does.” Fish Testimony, Tr. at 614.

18 It thus makes sense that APS be authorized to proceed with the proposed transaction,
19 thereby eliminating the risk that a substantially depreciated asset that has brought reliable
20 and cost-effective energy to Arizona customers for more than 40 years will be shutdown
21 prematurely.

22 **3. The APS Proposal Maintains the Diversity of APS’s Resource**
23 **Portfolio.**

24 The proposed transaction is further unique among alternatives in that it alone can
25 preserve APS’s well-balanced resource portfolio. As discussed during the hearing, the key
26 to resource planning and thus resource procurement is to structure a balanced energy
27 portfolio that manages the risks associated with all generation resources. *See* Dinkel
28 Testimony, Tr. at 495. Neither APS nor any other entity knows exactly what the future will

1 bring – future developments might make one resource more cost-effective or otherwise
2 beneficial than another. *See* Guldner Testimony, Tr. at 657. The way that a utility can
3 manage that uncertainty is to diversify its resource portfolio so that any adverse
4 development with respect to one resource does not adversely impact the utility or its
5 customers overall. *Id.* No party disputes that coal, though having a steady and inexpensive
6 fuel cost, is becoming increasingly subject to costly environmental regulations. No party
7 reasonably disputes that natural gas prices have been and will continue to be highly volatile,
8 particularly relative to coal. *See* APS Exhibit 8 at 9 (graph depicting ten-year historical
9 prices for natural gas versus coal); Patterson Testimony, Tr. at 991; Berry Testimony, Tr. at
10 929-930; Rose Testimony, Tr. 205-209; Schiavoni Testimony, Tr. at 323. In the event that
11 carbon taxes turn out to be more expensive than anticipated or if natural gas prices spike
12 because of new regulation or a hurricane strikes, maintaining a rough balance between these
13 resources protects APS and its customers from over-exposure to any single fuel. *See*
14 Guldner Testimony, Tr. at 657.

15 As the table on page 11 of Mr. Dinkel's Direct Testimony demonstrates, virtually all
16 of APS's energy growth in the next five years will be met with renewable energy and
17 energy efficiency. APS Exhibit 8 at 11-12. These resources require baseload generation
18 support. Schiavoni Testimony, Tr. at 328. If the proposed transaction is approved, APS
19 will maintain an energy portfolio that has a good balance between coal, nuclear, and natural
20 gas to provide that support. *See* APS Exhibit 8 at 11. The evidence was also clear that APS
21 presently intends to meet its future incremental baseload energy needs with natural gas. *See*
22 Dinkel Testimony, Tr. at 508. Indeed, APS's plan to maintain, but not materially increase,
23 the Company's coal exposure is an important reason for marrying the closure of Four
24 Corners Units 1-3 with the acquisition of SCE's interest in Units 4 and 5. *See* Schiavoni
25 Testimony, Tr. at 344-45; Dinkel Testimony, Tr. at 384-385. The natural gas component of
26 the Company's portfolio should thus only increase going forward. *Id.* at 508-509.

1 If the proposed transaction is *not* approved, APS's well-balanced resource plan is
2 disrupted and will be weighted heavily in favor of natural gas, which would grow in
3 contribution from 21% to 40% of the Company's energy mix by 2017. *See* APS Exhibit 8
4 at 10. Coal, on the other hand, would fall dramatically from a 33% contribution to a low
5 14%. *See* APS Exhibit 8 at 11. That disruption alone could cause gas costs through the
6 Company's Power Supply Adjustor ("PSA") to increase by \$300 million per year. *See*
7 Dinkel Testimony, Tr. at 391. The balance would be disrupted even further if APS loses
8 other coal generation from its interest in Navajo Generating Station, which faces many of
9 the same challenges now facing Four Corners and is also at risk. *See* Guldner Testimony,
10 Tr. at 658; APS Exhibit 8 at 3. If that were to occur, only one coal asset (Cholla) would
11 remain in APS's generation fleet, rendering coal – a cheap and reliable resource – a mere
12 9% portion of the Company's resource portfolio. *See* APS Exhibit 8 at 11. Assuming that
13 any lost coal generation is replaced with natural gas, natural gas would thus make up almost
14 half of the Company's portfolio, over-exposing customers to a highly volatile fuel and the
15 potential for enormous, unanticipated cost increases through the Power Supply Adjustor.
16 *See* Dinkel Testimony at 508-509 [others re PSA and fuel volatility]. As one witness put
17 it:

18 One of the things that the Commission will have to deal with [if it
19 does not authorize the proposed transaction] is if a hurricane comes
20 through the Gulf and you're watching the TV and gas prices are going
21 through the roof. If you hadn't closed on this transaction, you're
22 more exposed to the gas prices than you otherwise would. So there's
a real good reason to move forward in addition to the complexities of
this particular deal. So the volatility of gas is high, and it's a
significant issue that remains.

23 Rose Testimony, Tr. at 206. The risk of over-exposure to that kind of price volatility is
24 precisely the resource planning risk that the proposed transaction seeks to hedge. *See*
25 Guldner Testimony, Tr. at 658.

26 **B. *The APS Proposal Is Good for the Navajo Nation.***

27 No party disagreed that the proposed transaction removes any potential that Four
28 Corners would shutdown entirely when SCE withdraws from the plant in 2016, thus

1 protecting the Navajo Nation from consequences that are nothing short of devastating. *See*
2 Schiavoni Direct Testimony at 9. And no party disagreed that the Commission should
3 consider the impact to the Navajo community when it rules on the Company's Application.
4 The following is undisputed.

5 Four Corners is the economic lifeblood of the Navajo Nation, contributing millions
6 of dollars in payroll and tax revenue to the Navajo Nation and surrounding community. *See*
7 Schiavoni Direct Testimony at 3. Together, Four Corners and the Navajo mine provide jobs
8 to roughly 1,000 people, more than 75% of whom are Native American. *Id.* The combined
9 annual payroll is over \$100 million, a key contribution to the local economy. *Id.* The
10 Navajo Nation receives approximately \$65 million in tax and royalty payments annually as
11 a result of plant operations, making up an impressive 35% of the Nation's total general
12 fund. *Id.* Federal, state, and local economies also benefit from nearly \$40 million in tax
13 payments that Four Corners and the Navajo mine make each year. *Id.* Plant operations
14 support local vendors as well, contributing an estimated \$20 million annually for the
15 services and goods those vendors provide. *Id.*

16 The Navajo Nation reports that it already suffers from a more than 50%
17 unemployment rate – five times the national average. *Id.* at 4. The Four Corners Power
18 Plant, with the Navajo mine, is the largest employer on the reservation. *See* Schiavoni
19 Testimony, Tr. at 325. Mr. Schiavoni, who has spent time on the Navajo Nation interacting
20 with its people, illustrated the impact of Four Corners on an impoverished community from
21 his personal perspective:

22 I don't want to speak for the Nation, but I just do know that in my
23 interactions over the last two and a half years in negotiating the lease,
24 we have seen the impact to the Nation from unemployment. We have
25 seen it in the chapter houses. I visited the chapter houses. We speak
26 to the people in chapters, their needs. There is a significant need.
27 And we take something that contributes as much as it does to their
28 economy, \$65 million directly to their annual coffers, it will escalate
with CPI over time, you take into account the amount of employees
that are working there, the impact to that. All said and done, it is
about a \$225 million – on the conservative side – impact to that area.
And there is not another significant economic driver for the Nation at
this point in time.

1 Schiavoni Testimony, Tr. at 325.

2 On the other hand, if the proposed transaction moves forward, jobs will be saved and
3 no Four Corners employee will suffer a layoff as a result. *Id.* at 9. APS expects that all
4 position reductions resulting from the retirement of Units 1-3 will occur naturally, through
5 retirement or otherwise. *Id.* The Navajo Nation and surrounding community will continue
6 to benefit from over millions in yearly payroll revenue – a critical asset to the local
7 economy and the Navajo Nation will continue to receive tens of millions of dollars annually
8 in tax, fee and royalty contributions due to the continued operation of Units 4 and 5. *Id.*

9 **C. *The APS Proposal Is Good for the Environment.***

10 It was similarly undisputed that the proposed transaction results in the emission of
11 fewer environmental pollutants compared to what Four Corners emits today, providing a
12 cleaner energy resource for customers. Indeed, both the Environmental Defense Fund and
13 Western Resource Advocates – two parties that represent environmental interests –
14 expressly support the Application. *See* Hearing Testimony of Bruce Polkowsky
15 (“Polkowsky Testimony”), Tr. at 232-33; Berry Testimony, Tr. at 915.

16 If the Company’s Application is approved and the Company accelerates the
17 retirement of Units 1-3, the plant’s capacity will be reduced from 2,100 MW to 1,540 MW
18 and emission controls will be installed on Units 4 and 5. *See* APS Exhibit 11 at 7-8. As a
19 result, the plant will burn approximately 2.6 million fewer tons of coal each year compared
20 to what it would were all five units to remain online, significantly lowering the emission of
21 pollutants into the atmosphere. *Id.* at 8. This result thus significantly reduces Four Corners
22 site emissions compared to current levels. *Id.* Closing Units 1-3 alone reduces site
23 emissions for mercury by 61%, particulate matter by 43%, sulfur dioxide by 24%, and
24 carbon dioxide by 30%. *Id.* Retiring those units also reduces site NOx emissions by 36% –
25 a number that rises to 86% if post-combustion controls are installed on Units 4 and 5, as the
26 EPA has proposed. *Id.* The proposed transaction will also decrease water consumption at
27 the site by 20%. *Id.* Although APS will have slightly more coal in its portfolio as a result
28

1 of this transaction, the 179 MW increment will be cleaner and will have very little impact
2 on the Company's emissions profile compared to what it is today, and is better than what
3 the EPA proposed in its BART. *Id.*

4 In sum, the proposed transaction reduces pollutant emissions compared to what they
5 now are. *Id.*; Polkowsky Testimony, Tr. at 236-37. The improvement to visibility alone
6 would extend to 16 national parks and wilderness areas in and around New Mexico. *See*
7 Polkowsky Testimony, Tr. at 237. The environment benefits as a result.

8 **II. THE COMMISSION SHOULD AUTHORIZE THE PROPOSED**
9 **TRANSACTION UNDER THE TERMS OF THE SETTLEMENT**
10 **AGREEMENT ADOPTED IN DECISION NO. 67744.**

11 In order to proceed with the proposed transaction and reap these many benefits, the
12 Company must secure the Commission's authorization under the terms "self-build
13 moratorium" contained in the Settlement Agreement ("Agreement") approved in modified
14 form in Decision No. 67744. *See* Decision No. 67744 (April 17, 2005), Attachment A at
15 16. With just one exception, every party to opine on the issue recommends that the
16 Commission grant the Company's request for such authorization in this case, including both
17 Commission Staff and RUCO. Only the ACPA suggests that the proposed transaction
18 should not be approved, arguing in a strained and ever-evolving interpretation of the
19 requirements of Decision 67744 that APS cannot comply with its terms unless it first issues
20 an RFP. Patterson Testimony, Tr. at 937. No Commission rule or order supports the
21 ACPA's position.

22 Section IX of the Agreement prohibits APS from pursuing any "self-build" option
23 having an in-service date prior to January 1, 2015. (Decision No. 67744, Attachment A at
24 16.) This provision, one of several relating to competitive procurement, was included in the
25 Agreement to counterbalance a corresponding provision that allowed APS to acquire five
26 generation assets from an affiliate, Pinnacle West Energy Corporation ("PWEC"). *Id.* at 5.
27 As originally negotiated by the parties, this "self-build moratorium" would not have
28 required APS to secure the Commission's authorization for the Four Corners transaction.

1 *Id.* at 25, Attachment A ¶ 74. Rather, as defined by the signatories (of which ACPA was
2 one), “‘self-build’ does not include the acquisition of a generating unit or interest in one
3 from a non-affiliated merchant or utility generator . . .” *Id.*

4 When voting on the Agreement, however, the Commission modified the definition of
5 “self-build” to include transactions such as that proposed in the Company’s Application. *Id.*
6 at 25. In doing so, the Commission explained that: “We generally agree that the self-build
7 moratorium proposed in the Agreement is useful for addressing the potentially anti-
8 competitive effects that may be associated with rate-basing the PWEC assets. However, to
9 fully realize the benefits of the moratorium for that purpose, the moratorium should apply to
10 the acquisition of a generating unit or interest in one from any merchant or utility generator,
11 as well as building new assets.” *Id.* at 25. For that reason, the Commission required APS
12 “to obtain the Commission’s expressed approval for the acquisition of any generating
13 facility or interest in a generating facility,” irrespective of whether the acquisition resulted
14 “pursuant to an RFP or other competitive solicitation.” *Id.* Importantly, Decision No.
15 67744 defines “competitive solicitation” to include a bilateral contract with a non-affiliated
16 entity, the precise nature of APS’s contract with SCE. *Id.* at n. 35 (defining “competitive
17 solicitation” to include any solicitation issued pursuant to APS’s Secondary Procurement
18 Protocol); APS Secondary Procurement Protocol⁹ (identifying “bilateral contracts with non-
19 affiliated entities” as permissive protocol).

20 The Commission’s explanatory language makes clear that the “anti-competitive”
21 impact about which it was concerned applies equally to plant purchases from a merchant
22 power provider pursuant to an RFP as much as it does to APS buying an additional interest
23 in an existing power plant from another utility. *Id.* In other words, the Commission did not
24 intend for either the nature of the counterparty nor the chosen solicitation method to
25 determine whether the transaction is “anti-competitive.” The focus, instead, was on the fact
26 that APS would be acquiring a generation asset (as with the PWEC units) as opposed to

27 _____
28 ⁹ Filed with the Commission March 30, 2003 pursuant to Decision No. 65743 (March 14, 2003) in Docket
Nos. E-00000A-02-051, E-01345A-01-0822, E-00000A-01-0630, and E-01933A-02-0069)

1 buying energy from the market. *Id.* at 25. In such a case, the Commission wanted the
2 opportunity to determine whether the asset addition might impair how APS would access
3 the competitive market to meet its future energy needs. *See Id.* at 10-11, 25-26 (acquisition
4 of PWEC units was not “anti-competitive” because, even with the acquisition, APS’s future
5 energy needs would be unmet and the Company would have to procure additional power to
6 meet those needs).

7 To aid in this determination, Paragraph 75 of the Settlement Agreement requires that:

8 As part of any APS request for Commission authorization to self-
9 build generation prior to 2015, APS will address:

- 10 • The Company’s specific needs for additional long term resources,
- 11 • The Company’s efforts to secure adequate and reasonably-priced long-
12 term resources from the competitive wholesale market to meet these
13 needs,
- 14 • The reasons why APS believes those efforts have been unsuccessful,
15 either in whole or in part,
- 16 • The extent to which the request to self-build generation is consistent
17 with any applicable Company resource plans and competitive resource
18 acquisition rules or orders resulting from the workshop/rulemaking
19 proceeding described in paragraph 79, and
- 20 • The anticipated life-cycle cost of the proposed self-build option in
21 comparison with suitable alternatives available from the competitive
22 market for a comparable period of time.

23 *Id.* at Attachment A, Paragraph 75(a)-(e).

24 Although each of these topics must be addressed, none is dispositive of whether the
25 Commission should grant authorization. For one, the requirement of the paragraph is that
26 APS “address” the topics in any application for waiver of the “self-build” restriction, not
27 that the Company take action with respect to those items one way or another. In addition,
28 the above-quoted paragraph is immediately followed by language cautioning that “[n]othing
in this section [Section IX, Competitive Procurement of Power] shall be construed as
relieving APS of its existing obligation to prudently acquire generating resources, including
but not limited to seeking the above authorization to self-build a generating resource or
resources prior to 2015.” Decision No. 67744, Attachment A at ¶ 76.

1 As virtually every party to this matter attests, APS has satisfactorily addressed each
2 of these topics. *See, e.g.*, APS Application at 23-27; APS Exhibit 8 at 9-14; APS Exhibit 13
3 at 9; Staff Exhibit 2 at 5-23. This brief will take each subpart in turn:

4 **A. *APS's specific, unmet resource needs.***

5 With respect to ¶ 75(a) (that APS address its “specific, unmet needs for additional
6 resources), APS explained three things. First, this transaction was not about procuring
7 “additional” or incremental resources to meet the Company’s “future unmet needs” as much
8 as it was about preserving the value of an existing APS asset and maintaining the balance of
9 the Company’s resource portfolio. *See* Dinkel Testimony, Tr. at 487-488. As Mr. Dinkel
10 testified,

11 This acquisition was more about trying to retain value than it is,
12 quote, seeking capacity for growth. The net 179 megawatts, I hate to
13 say is incidental, but it is really a byproduct of trying to obtain value
14 for our customers, the environment, your environment, and
employees in the area. We are not approaching this for “we need 179
megawatts, let’s go do a solicitation. Quite the contrary.

15 *Id.* Second, even if the proposed transaction moves forward, APS will still require another
16 545 MW of resources to meet its 2017 load requirements. *See* APS Exhibit 8 at 12; Staff
17 Exhibit 2 at 5. And, if the proposed transaction does not move forward, the Company’s
18 need for new resources could increase to over 1,500 MWs in 2017. *See* APS Exhibit 8 at
19 12, Staff Exhibit 2 at 5.

20 **B. *Efforts to secure resources to meet those needs.***

21 Paragraph 75(b) requires APS to address its “efforts to secure adequate and
22 reasonably priced long-term resources from the competitive wholesale market to meet those
23 needs” (referring to the “unmet needs” prompted by ¶ 75(a)). Decision No. 67744,
24 Attachment A at 16. The evidence is clear that APS has amply addressed this prong. First
25 and foremost, the Company’s “specific unmet need” in this case was to preserve the value
26 of its existing Four Corners asset and maintain a well-balanced resource portfolio. *See*
27 Dinkel Testimony, Tr. at 487-488. In negotiating an arms-length contract for wholesale
28 coal generation with SCE – the only entity with an asset that could fill the Company’s

1 specific need – APS took the specific effort required to meet that very specific need. This
2 move was far from anti-competitive. As Mr. Guldner, who participated in the proceedings
3 underlying the self-build moratorium on behalf of the Company testified, when engaging in
4 a wholesale generation transaction such as this, SCE is as much a participant in the
5 “competitive wholesale electricity market” as the merchant firms represented by the ACPA.
6 *See Guldner Testimony, Tr. at 659, 707-708.*

7 Second, the “incidental” 179 MW of capacity that will result from the proposed
8 transaction will not materially change how APS will access the competitive market to meet
9 its future energy needs. Even if the proposed transaction moves forward, APS will require
10 545 MW of resources in 2017 to meet its load requirements. *See APS Exhibit 8 at PD-1.* In
11 2010, APS responded to two RFPs conducted by natural-gas fired merchant generators in an
12 “effort to secure” resources from the competitive wholesale market to meet these future
13 long-term energy needs. *See Furrey Testimony, Tr. at 1027.* APS further testified that,
14 having been unsuccessful in its bids, the Company will meet its additional 2017 load
15 requirements through a combination of renewable energy and competitively procured
16 natural gas generation. *APS Exhibit 8 at PD-1; Dinkel Testimony, Tr. at 508.* And, if the
17 proposed transaction fails, APS will likely turn to the competitive market for a (more
18 expensive) natural gas alternative to Four Corners generation at the appropriate time. *See*
19 *Dinkel Testimony, Tr. at 398.* The evidence thus clearly demonstrates the Company’s
20 commitment to securing resources from the competitive wholesale market to meet its unmet
21 future needs.

22 **C. *Why those efforts have been unsuccessful.***

23 Paragraph 75(c) requires APS to address “the reasons why APS believes those
24 efforts [referred to in ¶ 75(b)] have been unsuccessful, either in whole or in part.” Decision
25 No. 67744, Attachment A at 16. With respect to this prong, APS reiterated that the only
26 way that the Company could meet its “specific, unmet need” in this case was to find a way
27 to protect its existing coal resource from premature retirement. *See Dinkel Testimony, Tr.*
28

1 at 487-488. No party disputed that only the proposed transaction can fill this unique
2 resource need.

3 The evidence also made clear that APS would need a baseload resource to replace
4 any generation lost if Four Corners Units 4 and 5 were to retire, and that the market would
5 not be able to offer a coal or nuclear resource that would be available to meet that need on
6 the required timeline. *See* Dinkel Testimony, Tr. at 532; APS Exhibit 13 at 9; Staff Exhibit
7 2 at 7. A natural gas option is a likely alternative. *See* APS Exhibit 8 at 8. With respect to
8 that option, as described above, APS submitted two bids to merchant generators to acquire a
9 natural gas resource in early 2010 to meet a portion of the Company's future energy needs.
10 Those efforts were unsuccessful, likely because the price that APS bid for those assets was
11 too low. *See* Staff Exhibit 5 at 8; APS Exhibit 13 at 4. This effort informed APS's
12 understanding of what an existing natural gas resource would cost customers and bolstered
13 the Company's conclusion that the Four Corners transaction is by far the most economic.
14 *See Id.*

15 **D. *The anticipated life-cycle cost of the proposed transaction compared to***
16 ***suitable alternatives from the competitive market.***

17 Finally, Paragraph 75(e) of the Agreement requires APS to compare the anticipated
18 life-cycle costs of the proposed transaction to "suitable alternatives available from the
19 competitive market for a comparable period of time." Decision No. 67744, Attachment A
20 at 17. In its Application, APS explained why natural gas generation is not a "suitable
21 alternative" to baseload coal generation. *See, e.g.*, APS Exhibit 8 at 8-11. Even so, the
22 Company presented two analyses comparing the life cycle cost of acquiring SCE's share of
23 Four Corners Units 4 and 5 against a natural gas option: the Company's and that of Mr.
24 Rose. *See* APS Exhibit 8 at 13; APS Exhibit 9-10. Both of these analyses demonstrated
25 that the proposed transaction (including the cost of environmental upgrades) is far less
26 expensive than the alternatives. *See infra* at Section 1(A).
27
28

1 E. *Consistency with APS's resource plan and the Commission's competitive*
2 *procurement rules.*

3 Paragraph 75(d) requires APS to address "the extent to which the request to self-
4 build generation is consistent with any applicable Company resource plans and competitive
5 resource acquisition rules or orders" No party has challenged APS's explanation of
6 why and how the proposed transaction is consistent with the Company's last filed resource
7 plan. *See* APS Exhibit 8 at 13; Staff Exhibit 2 at 10-11. Indeed, the Company's Resource
8 Plan echoes the interests articulated throughout the underlying proceedings in preserving
9 diversity among fuel resources, maintaining a balanced portion of coal in its resource
10 portfolio, and limiting reliance on natural gas so as to mitigate the risk of exposure to fuel
11 cost volatility. *Id.* The proposed transaction achieves each of these goals.

12 The proposal is also fully consistent with the Commission's competitive
13 procurement rules, contained in Arizona Administrative Code R14-2-705 ("Procurement").
14 Those rules allow APS to procure generation through a "bilateral contract with a non-
15 affiliated entity," such as the Asset Purchase Agreement between SCE and APS, "except as
16 provided under Subsection B." Subsection (B) requires APS to "use an RFP process as its
17 primary acquisition process for the wholesale acquisition of energy and capacity" unless,
18 among other things, "[t]he transaction presents the load serving entity a genuine,
19 unanticipated opportunity to acquire a power supply resource at a clear and significant
20 discount, compared to the cost of acquiring new generating facilities, and will provide
21 unique value to the load-serving entity's customers." A.A.C. R14-2-705(B). The proposed
22 transaction clearly falls within both the spirit and the letter of these rules.

23 As a general matter, there is little doubt that APS has and will continue to "use an
24 RFP process as its primary acquisition process." A.A.C. R14-2-705(B). The undisputed
25 evidence demonstrates that since Decision No. 67744 was ordered in 2005, APS has used
26 an RFP process as its resource procurement method almost without exception, procuring
27 more than 2,000 MW of capacity from RFPs in less than six years. *See* Dinkel Testimony,
28

1 Tr. at 400. Moreover, APS plans on adding another 3,500 MW of gas resources within its
2 resource planning horizon, all of which APS anticipates will be procured through RFPs. *Id.*

3 In addition, the proposed transaction falls well within one of the rule's many
4 exceptions to what some have referred to as the "preference for RFPs." *See* A.A.C. R14-2-
5 705(B)(5). The exception on which APS relies, expressed in R14-2-705(B)(5), has four
6 prongs: (1) that the transaction in question presents APS with an "opportunity to acquire a
7 power supply resource at a clear and significant discount, compared to the cost of acquiring
8 new generation facilities;" (2) that such an opportunity be "genuine;" (3) that such an
9 opportunity be "unanticipated;" and (4) that such an opportunity "provide unique value to
10 the load-serving entity's customers." The opportunity to acquire SCE's share of Units 4
11 and 5 and offset the additional generation by retiring Units 1-3 fully satisfies each of these
12 prongs.

13 First, there is little dispute that the proposed transaction is an opportunity for APS to
14 acquire an asset at a "clear and significant discount" relative to the cost of "new generation
15 facilities." Indeed, the revenue requirement in the record associated with constructing new
16 natural gas facilities is around \$1,253/kW – a figure that was generally undisputed. *See*
17 APS Exhibit 8 at 10; Rose Testimony, Tr. at 136; Fish Testimony, Tr. at 631. Although
18 ACPA and Sierra Club questioned APS's assumptions as to what it would cost to acquire an
19 *existing* asset, that inquiry is not the relevant one for the purposes of the procurement rules.
20 To that point, a comparison to new build shows that the contract price that APS negotiated
21 for SCE's interest in Units 4 and 5 is "one-tenth the cost of replacement of a new coal-
22 powered plant," making the proposed transaction "an extraordinary opportunity for the
23 citizens and the ratepayers, customers of APS to save money." Rose Testimony Tr. at 138,
24 180-181. But whether the comparison is to new or existing facilities, the evidence
25 demonstrates a significant customer revenue requirement savings of at least \$500 million
26 net present value compared to a natural gas alternative – a clear and significant discount.
27 *See supra* Section A(1).

28

1 Second, there was no question that the opportunity identified in the Application is a
2 “genuine” one that will “provide unique value to the load-serving entity’s customers.”
3 Indeed, the proposed Four Corners transaction, alone of the options, allows customers to
4 continue to benefit from the low-cost energy produced by APS’s existing interest in Units 4
5 and 5, now substantially depreciated and remarkably valuable. Even the ACPA concedes
6 this point. *See* Patterson Testimony, Tr. at 1017 (describing APS’s existing interest in Units
7 4 and 5 as “ownership in what is the cheapest asset you can essentially get, which is a
8 nearly fully depreciated coal plant.”) In addition, the proposed transaction brings other
9 unique benefits that cannot collectively be met by any alternative: maintaining the balance
10 of APS’s diverse resource portfolio, lowering Four Corners’ emissions rate and protecting
11 the environment, and preserving the economic well-being of the Navajo people. *See supra*
12 at Section 1(A)-(C). The multi-faceted and unique value of this deal compared to others is
13 clear.

14 Finally, except for ACPA, all of the parties to opine on the issue agree that the
15 opportunity to acquire SCE’s interest in Units 4 and 5 and counterbalance that acquisition
16 by retiring Units 1-3 was “unanticipated.” Staff Exhibit 2 at 17. SCE’s departure from the
17 Four Corners project was the product of a shift in California policy away from coal-fired
18 generation (and some other resources) that began to take legislative and regulatory form in
19 2006 and has been evolving ever since. *See, e.g.*, Staff Exhibit 2 at 16-18. Although APS
20 had some awareness that California had passed regulations that could ultimately impact
21 SCE’s ability to participate in coal projects, neither APS, SCE nor any of the other project
22 participants had any clear understanding of what the change in California environmental
23 policy would require of SCE and when. *See* Schiavoni Testimony, Tr. at 285-86. Indeed,
24 SCE had applied for an exemption from the California regulations with respect to Four
25 Corners, which the CPUC did not finally rule on until October of 2010. *See, e.g.*, Staff
26 Exhibit 2 at 17.

1 It was not until December 2009 that SCE's co-owners were first notified as to SCE's
2 specific intentions with respect to the plant sell to a project participant or proceed with
3 "harvesting" the units. *See* Schiavoni Testimony, Tr. at 287, 345. This timing coincided
4 with certain EPA developments with regard to the environmental upgrades that would be
5 required at all five of Four Corners' existing units, and the upcoming expiration of virtually
6 all of the agreements governing the plant (the lease with the Navajo Nation, the fuel
7 agreement, and the two participant operating agreements). *Id.* at 343-344. The intersection
8 of all of the various issues facing the plant at almost a single point in time presented APS
9 with the opportunity that this Application describes: to acquire SCE's interest in Units 4
10 and 5 at a striking customer value and offset the unplanned generation addition by retiring
11 Units 1-3 (less able than Units 4 and 5 to economically bear the cost of the EPA's
12 anticipated environmental upgrades). *Id.* The opportunity to resolve all of the various
13 issues facing the plant with such unique customer and community benefits was, indeed,
14 unanticipated. *Id.* As Mr. Guldner testified,

15 I don't think there is any other party that had the opportunity to come
16 up with a proposal that would allow the closure of three existing
17 units, the environmental benefits, the value that brings to the Navajo
18 Nation of keeping jobs for the Navajo, and at the same time manage
19 through a very complex proceeding. And so it wasn't something
20 where years ago we had planned to acquire Edison's interest in the
21 Four Corners units. It was an opportunity that was presented to us.
22 We moved quickly on it and we brought that opportunity to the
23 Commission.

24 Guldner Testimony, Tr. at 656.

25 The ACPA argues that the opportunity underlying this Application was not
26 "unanticipated" because "Mohave shut down in '05" and "it's been pretty obvious where
27 coal has been going for the last six or seven years." Patterson Testimony, Tr. at 950. Such
28 an argument too narrowly understands the nature of the opportunity (self-interestedly
divorcing the closure of Units 1-3 from the acquisition of Units 4 and 5) and too strictly
construes the nature of the exception. Too narrow an interpretation of whether or not an
opportunity was "unanticipated" under R14-2-705(B)(5) will easily swallow the rule, which

1 is why it must be construed with a “functional view.” Guldner Testimony, Tr. at 653. As
2 one witness who participated in the various proceedings underlying the existing resource
3 procurement rules testified, the intent of this and other exceptions was to recognize that not
4 all prudent investment opportunities can result from one specific procurement process.
5 Guldner Testimony, Tr. at 654. The aim of the Commission’s procurement rules was not
6 only to make sure that APS uses an RFP as its primary acquisition process (which APS
7 does), but also to allow the Company to take advantage of exceptional opportunities that do
8 not lend themselves to the RFP process when they arise. The proposed transaction is one
9 such exception of which, in the words of RUCO’s expert witness, “we would be remiss in
10 not taking advantage.” Fish Testimony, Tr. at 580.

11 As the foregoing demonstrates, nothing about the proposed transaction runs afoul of
12 the Commission’s interest in supporting the competitive wholesale market. By acquiring
13 SCE’s share of Units 4 and 5 and retiring Units 1-3, APS is not adding any material amount
14 of generation to its resource portfolio that would displace what APS had otherwise intended
15 to procure by way of an RFP or similar procurement method. Even with the proposed
16 transaction, APS will need additional energy resources beginning as early as 2017 and
17 intends to turn to the competitive wholesale market to meet those needs. Indeed, the
18 Company has already bid into two RFPs issued by merchant generators in anticipation of
19 those requirements. Throughout the proceeding, APS demonstrated its commitment to
20 procuring resources from the competitive market and explained why, notwithstanding that
21 commitment, the proposed transaction is a prudent one for customers. By filing this
22 Application, APS has complied with Paragraph 76 of the Agreement which requires APS to
23 seek authorization to “self-build” where doing so is consistent with the Company’s
24 “obligation to prudently acquire generating resources.” The Commission should allow the
25 Company to close the transaction accordingly.

1 **III. APS'S REQUEST FOR AN ACCOUNTING ORDER SHOULD BE**
2 **GRANTED.**

3 The purpose of a deferral accounting order is to allow APS to capitalize certain costs
4 that would otherwise be expensed or foregone until a future rate proceeding. These costs
5 can be operating and maintenance expenses, taxes, and interest, all of which are routinely
6 included in authorized accounting orders. The equity used to acquire an asset also has a
7 cost, hence the use of the term "cost of equity" in virtually every rate case before the
8 Commission. Although the cost of equity is not "expensed" in the same accounting sense
9 as interest, taxes, etc., its loss produces the identical financial impact – reduced overall
10 return on the Company's plant and equipment.

11 Once the determination is made as to which costs should be deferred, there is the
12 question of whether to allow a return on the deferred cost balance, *i.e.*, compounding.
13 Although anyone who deposits money in a savings account naturally expects to earn a
14 compounded return, this compounding concept has been an issue in some prior Commission
15 proceedings considering accounting order requests, as will be discussed below.

16 **A. *The Balance of Equities Supports Granting the Requested Accounting***
17 ***Order.***

18 In conjunction with and in support of its proposed acquisition, APS has requested
19 that the Commission grant an accounting order that will allow APS to defer and capitalize
20 for future recovery through rates all non-fuel costs of owning, operating, and maintaining
21 the acquired interest in Four Corners Units 4 and 5. An accounting order (sometimes also
22 referred to as a "rate synchronization order") is a regulatory mechanism that provides APS
23 the ability to defer costs for future ratemaking consideration that would otherwise be lost
24 forever. In this case, such an order will address the timing mismatch between costs and
25 benefits that occurs due to the difference in time between when the proposed transaction
26 closes (providing an immediate cost-benefit to customers) and when APS is allowed to
27 include the asset in rates. *See* Decision No. 55939 (April 6, 1988) at 3.
28

1 The costs to be deferred include depreciation, amortization of the acquisition
2 adjustment,¹⁰ incremental operations and maintenance expense, incremental property taxes,
3 final coal reclamation costs, capital carrying charges (i.e., pre-tax return on the acquisition
4 cost based on the weighted cost of capital established in the Company's pending rate case)
5 and other miscellaneous costs. As discussed below, the specific language APS has proposed
6 comes directly from the Commission's order in Decision No. 66774 and has already been
7 found acceptable by the Company's outside auditor. *See* APS Exhibit 15 at 13.

8 APS has also requested that it be allowed to capitalize a return on all of the deferred
9 costs, including those discussed above. Deferred costs such as O&M, taxes, interest and
10 equity returns themselves represent investments on which APS needs to be able to earn a
11 return. This is how the Allowance for Funds Used During Construction ("AFUDC") – the
12 equivalent of an accounting deferral order for plant not yet in service– is calculated
13 pursuant to both FERC's and this Commission's guidelines. *See* A.A.C. R14-2-212(G) and
14 Decision No. 53761 (September 30, 1983) at 27-28.¹¹

15 APS customers will see substantial long-term cost savings if the proposed transaction
16 is approved, as discussed in Mr. Dinkel's Testimony (APS Exhibit 8). Those savings,
17 however, come at a significant short-term cost that would have to be absorbed entirely by
18 APS, absent a deferral. *See* Staff Exhibit 3 at 7. There is, for example, the \$294 million
19 purchase price and the increased operating and maintenance expenses associated with the
20 additional ownership in Units 4 and 5. APS will also assume certain of SCE's assets and
21 liabilities (such as those associated with final plant decommissioning and coal reclamation),
22 which APS will record at fair value at the time of the acquisition. Collectively, these new
23 costs amount to an estimated revenue requirement of over \$70 million for the first year. *See*
24

25 ¹⁰ The acquisition adjustment consists of the difference between the acquisition price to be paid to SCE and
26 the book value of SCE's interest in Four Corners at the time of closing. APS proposes to amortize this
amount over the remaining life of the plant, similar to how depreciation is treated.

27 ¹¹ ACC and FERC regulations on AFUDC require APS to defer all capital costs on construction
28 expenditures, including debt and equity return, prior to the plant being placed into service. Thereafter,
AFUDC is discontinued. *See* Decision No. 53761, citing FERC requirements, authorized the return to be
compounded.

1 APS Exhibit 14 at 8. If APS is not able to defer these costs, it will forever lose the
2 opportunity to recover them irrespective of their prudence and despite the significant
3 benefits the overall transaction will have conferred on customers both in the short and long
4 runs. *See id.*

5 This inequitable result is amplified by the Company's PSA. Under that adjustment
6 mechanism, customers will immediately benefit from the fuel savings that will result from
7 the proposed transaction. But, absent a deferral, APS will have no mechanism to offset the
8 transaction's significant costs except for the 10% share of the savings afforded by the
9 current 90/10 sharing provision in the PSA. Put another way, APS customers will pay less
10 because of this transaction after it closes, but will not be required to pay for it until the
11 acquisition is reflected in rates in a subsequent rate case. The Company will incur
12 significant new costs to own and operate Units 4 and 5, but will not be able to offset those
13 cost increases in any meaningful way with the anticipated fuel savings. A deferral order will
14 partially remedy this mismatch until the increased costs are reflected in rates. *See APS*
15 *Exhibit 14 at 7-8.*

16 Finally, the Company was not and is not able to simply file a new rate case to
17 include the to-be acquired interest in Four Corners Units 4 and 5 at its leisure so as to avoid
18 the financial erosion caused by regulatory lag. Both the filing dates of APS's pending rate
19 case and of its next, along with their test periods, were and are constrained by the Rate Case
20 Filing Plan in the Company's 2009 Rate Case Settlement. *See Decision No. 71448.*

21 **B. *The Requested Accounting Deferral Order is Fully Consistent with***
22 ***Regulatory Precedent Both in and Outside of Arizona***

23 **1. Arizona**

24 Although Arizona has authorized deferral accounting in conjunction with the phase-
25 in of an existing asset,¹² a more analogous situation to the present transaction regarding
26 Four Corners was the Commission's treatment of Palo Verde Units 2 and 3 from their

27 ¹² *See Decision No. 55228 (October 9, 1986)* – phase-in of Palo Verde common plant over each of the three
28 units required authorization of full cost deferral for two-thirds of the common plant's O&M and capital costs
retroactive to the in-service date of Unit 1.

1 respective in-service dates until the Commission could consider their inclusion in rate base.
2 Later, the Commission granted deferral orders to Tucson Electric Power Company (“TEP”)
3 in conjunction with Springerville Unit 2 and again to APS as part of the Commission’s
4 approval of the Company’s acquisition of the Sundance Units (“Sundance”) from PP&L.
5 This brief will address each of these Commission decisions in turn.

6 *a) PV-II*

7 “It is increasingly questionable whether accounting or rate synchronization orders
8 can be characterized as ‘non-traditional’. However, even if they were, this is hardly a reason
9 to reject APS’s proposal.” Decision No. 55325 (December 5, 1986) at 5. Those words were
10 memorialized by this Commission nearly a quarter of a century ago. The Commission went
11 on to add: “In a perfect regulatory world, there would be little time between the introduction
12 of large increments of plant into service and the setting of rates which took that plant into
13 consideration.” *Id.* Notably, the Commission’s decision to allow a full deferral order for
14 Palo Verde Unit 2, including equity return and including a compounded return on the
15 deferred amounts, was based largely on the need to synchronize the incurrence of APS’s
16 costs with their recovery.

17 *b) PV-III*

18 “In recent years, these traditional regulatory principles have given way to an
19 accounting convention designed to prevent significant mismatches in revenues and
20 expenses occasioned by the inability to simultaneously introduce large increments of plant
21 into service and set rates which reflect that plant.” Decision No. 55939 at 3. In this
22 statement, made 20 years ago, this Commission recognized that the outdated paradigm of
23 building or acquiring major new plant additions and then waiting up to two years or longer
24 to begin recovering its costs in rates was neither fair to the utility nor likely to allow the
25 utility to maintain its financial health during inevitable periods of significant plant
26 expansion. For this reason, the Commission approved a deferral order for Palo Verde Unit
27 3, including the Company’s request for a debt return on the capital cost of the plant
28

1 (although it declined to allow a compounding of that return, which APS had requested).

2 The Commission concluded:

3 Issuance of an accounting order will properly synchronize cost
4 recording with cost recovery. Synchronization is necessary to prevent
5 the unfair mismatch of revenues and expenses which would otherwise
6 occur if PV-3 non-fuel operation costs are currently expensed,
without reimbursement from ratepayers, even though ratepayers are
receiving service from the Unit and benefiting from its lower fuel
costs pursuant to our decision in Docket No. U-1345-87-069.

7 *Id.* at 4-5.

8 *c) Springerville Unit 2*

9 In Decision No. 57586 (October 11, 1991), the Commission again approved an
10 accounting order regarding TEP's Springerville Unit 2 coal generating plant. The
11 Commission authorized full deferral of O&M and a debt-based return of 7.19% on both the
12 plant and the deferred cost balance. Interestingly, the granting of a deferral order for large
13 increments of new generating capacity was now so common that the Commission did not
14 feel it necessary to mention the deferral in the order itself – only in the attached settlement
15 agreement. It is not until in Decision No. 58497 (January 13, 1994) that the Commission
16 finally gets around to describing in an order the terms of the 1991 deferral, including the
17 7.19% compounded debt return. *See* Decision No. 58497 at 6-7.

18 *d) Sundance*

19 There was some disagreement at hearing over what the Commission's order in the
20 Sundance proceeding (Decision No. 67504 (January 20, 2005)), did or did not authorize in
21 the way of a cost deferral. A review of the Sundance decision makes clear, however, that
22 the Commission authorized APS to defer a return on the Sundance plant at APS's
23 embedded cost of debt but did not permit APS to compound that return by also deferring a
24 return on the total deferred balance.

25 The language of the Sundance order clearly indicates that, with the exception of
26 overhead costs (discussed later in this Brief) and subject to offsets for purchased power
27 savings and off-system sales attributable to Sundance, APS was permitted to defer all costs
28

1 of “owning, operating and maintaining the Sundance Generating Station.” See Decision No.
2 67504 at 49. As the Staff testimony in the Sundance proceeding explained, the costs of
3 “owning, operating, and maintaining” the plant specifically included “O&M, depreciation,
4 taxes, and cost of capital.”¹³ Michlik Testimony, Tr. at 1077-78 (emphasis added). Staff’s
5 post-hearing briefs in the Sundance matter also made clear that Staff’s quarrel was not
6 whether APS should be allowed to include a cost of capital as part of the deferral balance
7 (Staff recommended that it should), but whether APS should be allowed to apply the cost of
8 money to the deferred costs (which costs would include a debt return). *Id.* at 1077-80. In
9 other words, similar to the case of PV-III, the issue was whether the deferrals themselves
10 could accrue a return and not whether a return on the underlying asset could be deferred.
11 Indeed, no previous Commission power plant deferral order or, as is discussed below, no
12 deferral order in the analogous circumstance of a new generating plant anywhere in the
13 country had denied deferral of a return on capital – the principal cost of owning the asset.
14 This fact makes Staff’s apparent reinterpretation of Decision No. 67504 in this case
15 implausible, to say the least.

16 2. Other Jurisdictions

17 Each of the accounting orders granted by this Commission that were discussed above
18 permitted APS and TEP to defer a cost of capital (either the cost of debt or the cost of debt
19 and equity). In TEP’s case, such deferral was permitted even on the portions of
20 Springerville deemed to be “excess capacity.” And, in the United States generally,
21 including the cost of capital in a deferral authorization is typical if not universal for
22 transactions of this sort. (APS has located no examples to the contrary.) For example, in the
23 State of Washington, a statute and implementing regulation specifically allow deferral of
24 “operating and maintenance costs, depreciation, taxes, and cost of invested capital” for the
25 acquisition of base load generation.¹⁴ Several deferral orders have been issued to Puget

26 ¹³ Staff’s testimony and post-hearing briefs in the Sundance proceeding were adopted by the Commission’s
27 final order.

28 ¹⁴ Wash. Rev. Code 480-100-435 (2007).
<http://apps.leg.wa.gov/wac/default.aspx?cite=480-100-435>

1 Sound Energy (“PSE”) under this statute and regulation. For example, PSE was allowed to
2 include “the monthly cost of capital” in its authorized deferral for costs associated with the
3 acquisition of Goldendale Generating Station.¹⁵ PSE was similarly permitted to include “a
4 return of and on the plant investment plus the accrual of interest on the deferred balance”
5 related to its purchase of a combined cycle plant at Mint Farm.¹⁶ In a 2004 deferral order,
6 the Nevada Commission allowed Nevada Power Company to include capital carrying costs
7 in the deferral authorized for Nevada Power’s acquisition of the Moapa Generating
8 Station.¹⁷ Just last year, the Colorado Commission granted the Public Service of Colorado
9 (“PSCo”) cost recovery equivalent to a deferral order for PSCo’s acquisition of two Calpine
10 generation plants.¹⁸ The revenue requirements deferred in that case included all
11 jurisdictional costs, including return on the capital invested by PSCo. In 2008, the
12 Oklahoma Corporation Commission granted Oklahoma Gas & Electric Company (“OG&E”)
13 a deferral order that included a tax-affected (pre-tax) return based on OG&E’s last
14 authorized cost of capital for OG&E’s acquisition of the Redbud Generating Facility.¹⁹
15 And, in an order issued earlier this year, the North Carolina Utilities Commission
16 authorized a full deferral, including cost of equity on a \$583 million pollution control
17 device installed by Duke Energy at its Cliffside coal plant.²⁰

18
19
20 ¹⁵ See PSE Rate Case No. UE-070533 Order No. 01 (April 11, 2007),

21 <http://www.utc.wa.gov/docs/Pages/FilingIdBrowser.aspx>.

22 ¹⁶ See PSE Rate Case No. UE-082128 Order No. 03 (April 17, 2009),

23 <http://www.utc.wa.gov/docs/Pages/FilingIdBrowser.aspx>.

24 ¹⁷ See Nevada Public Utilities Commission Docket Nos., 04-6029/04-6030 (September 21, 2004),

25 <http://pucweb1.state.nv.us/PUCN/Dktinfo.aspx?Util=ElectricClosed>.

26 ¹⁸ See Public Utilities Commission of Colorado Docket No. 10A-327E (October 10, 2010),

27 https://www.dora.state.co.us/pls/efi/EFI_Search_UI.Show_Decision?p_session_id=&p_dec=14863.

28 ¹⁹ See Oklahoma Corporation Commission Decision No. 559892, Cause No. PUD 200800086 (September 23, 2008), <http://imaging.occeweb.com/AP/Orders/OCC3855094.PDF>.

²⁰ See North Carolina Utilities Commission Docket No. E-7, Sub 966 (June 27, 2011), [http://ncuc.commerce.state.nc.us/cgi-](http://ncuc.commerce.state.nc.us/cgi-bin/webview/senddoc.pgm?dispfmt=&itype=Q&authorization=&parm2=LCAAAA87111B&parm3=000134320)

[bin/webview/senddoc.pgm?dispfmt=&itype=Q&authorization=&parm2=LCAAAA87111B&parm3=000134320](http://ncuc.commerce.state.nc.us/cgi-bin/webview/senddoc.pgm?dispfmt=&itype=Q&authorization=&parm2=LCAAAA87111B&parm3=000134320).

1 **C. *The Deferred Balance Should Include the Cost of Capital.***

2 The only parties to address the Company's request for an accounting order are
3 Commission Staff and RUCO. Each of those parties clearly supports the proposed
4 transaction. As noted earlier, RUCO's witness, Dr. Fish, testified that "in my opinion, no
5 one could reasonably envision situations where the Company's requested alternative is not
6 best." See Testimony of Thomas H. Fish ("Fish Testimony") (RUCO Exhibit 1) at 14.
7 Staff's witness Ms. Little similarly testified. See Little Testimony, Tr. at 570, 575.

8 Commission Staff also agrees with APS that the mismatch between costs and rates
9 exacerbated by the PSA "provides additional impetus for granting regulatory relief" in the
10 form of a cost deferral. See Staff Exhibit 3 at 9. And although RUCO initially
11 recommended that the Commission deny APS's request for an accounting order, it changed
12 that recommendation during the course of the hearing. According to its witness, RUCO
13 was persuaded by APS's rebuttal testimony that the circumstances in this case warrant an
14 accounting order. See Fish Testimony, Tr. at 579. As Dr. Fish testified, "the customers that
15 are represented by RUCO are not benefited by harming the company, so we have no intent
16 of doing so." Fish Testimony, Tr. at 593.

17 Notwithstanding their clear support for the transaction and corresponding recognition
18 that a cost deferral would appropriately prevent APS from being financially penalized for
19 making the investment required, Staff would nevertheless prohibit APS from being allowed
20 to defer the financing costs that APS must pay to get the money needed if it is to purchase
21 the generation asset. Those financing costs, both debt and equity, are every bit as real as the
22 property taxes and O&M that APS must pay to own SCE's share of Units 4 and 5. As Mr.
23 Guldner explained, "we don't have \$294 million just sitting back at the office . . . You're
24 going to have to get that cash from somewhere. So there's a cost associated with it."
25 Guldner Testimony, Tr. at 763. Dr. Fish appears to agree, at least as to the debt component,
26 testifying that, "I do think they [APS] have a right to recovery of the interest they pay on the
27 debt because that's a fixed amount." Fish Testimony, Tr. at 629.
28

1 As APS Exhibit 17 depicts, the cost of capital makes up more than 50% of the \$71
2 million annual revenue requirement associated with the Four Corners transaction. The
3 evidence is also clear that, absent an order authorizing deferral of that cost, it will be
4 permanently lost. *See* Michlik Testimony, Tr. at 1068; APS Exhibit 14 at 8. Thus, not only
5 is Staff's position inconsistent with what appears to be universal regulatory precedent, it
6 would greatly impair the value and purpose of the accounting order that both parties agree is
7 appropriate.

8 Neither is including a cost of equity and debt as part of the deferred balance
9 "guaranteeing" a return on the acquired share of Four Corners Units 4 and 5, as RUCO and
10 Staff have argued. *See* RUCO Exhibit 1 at 31; Fish Testimony, Tr. at 627. Granting a
11 deferral will not bias the ultimate ratemaking treatment of the asset – it does not
12 "guarantee" the Company anything. Even if the Commission allows for rate inclusion of
13 any deferred amounts, APS's subsequent ability to actually recover those dollars through
14 future sales is as much at risk as it is for any other test period expense. *See, e.g.,* Staff
15 Exhibit 3 at 10-11.

16 On the other hand, if cost of capital is not included in the deferral, it is "guaranteed"
17 that APS will forever lose the opportunity to recover it. *See* Staff Exhibit 3 at 7; Guldner
18 Testimony, Tr. at 763. An accounting order with such a dramatic limitation would not
19 serve its intended purpose and would amount to an arbitrary disallowance of nearly \$40
20 million per year. Even after the asset is finally reflected in rates, this foregone return
21 represents a permanent loss. Requiring APS to forfeit such a significant amount would be
22 unjust, particularly considering the remarkable value of the transaction for customers, the
23 limitations on APS's ability to file a rate case, APS's offer to net the O&M savings related
24 to the shutdown of Units 1-3 against the deferral balance, and the fact that, because of the
25 PSA, APS will not be able to offset the transaction costs with the more than \$40 million per
26 year of fuel savings that will immediately flow through to customers through the PSA.
27 Indeed, as a practical matter, if the Commission adopts this recommendation, it increases
28

1 the risk that the proposed transaction will not be consummated and its benefits lost. *See*
2 APS Exhibit 15 at 4.

3 At hearing, the question also arose as to whether the fact that APS may continue to
4 earn a return on Four Corners Units 1-3 until its next filed rate case even though the asset
5 may be retired in the interim should justify a reduction to the deferral amount authorized
6 with respect to Units 4 and 5. *See* Guldner Testimony, Tr. at 887-892. As a general matter,
7 APS agrees that certain expenses relating to Units 1-3 that are now in rates should be offset
8 from the authorized deferral amount, provided that APS will have the opportunity to
9 actually avoid those expenses when Units 1-3 retire. For example, to the extent the
10 proposed transaction will save APS from having to pay O&M expense or property tax
11 relating to Units 1-3, and those same expenses are included in current rates, it makes sense
12 to offset those amounts from the deferral – indeed, APS has proposed to do so. *See* APS
13 Exhibit 14 at 9-10.

14 That same logic, however, does not apply to the cost of capital required on the
15 remaining balance of Units 1-3 – that is a sunk cost that will not be saved by an earlier-than
16 anticipated retirement of those units. *See* Guldner Testimony, Tr. at 889-890. Offsetting
17 the capital costs required to finance the transaction with SCE by the capital costs remaining
18 on Units 1-3 is akin to forcing the Company to take a partial write-off on Units 1-3 without
19 any finding of imprudence. *Id.* No party has suggested that an early retirement of Units 1-3
20 as proposed in the Application is imprudent or otherwise inappropriate. Quite the contrary:
21 Commission Staff expressly recommended that APS *not* take a write off of any unrecovered
22 costs relating to Units 1-3. *See* Staff Exhibit 3 at Executive Summary (recommending
23 “[d]enial of APS’s request for assurance of recovery for all unrecovered costs associated
24 with Four Corners Units 1-3; however, APS shall account for those costs under the
25 assumption that the Commission will continue to consider these costs available for future
26 recovery unless and until otherwise determined (i.e., these costs should not be prematurely
27 written off)”). APS agrees with Staff that the recovery of costs related to Units 1-3 post-
28

1 retirement is an issue that should be considered in a rate case. *See* Guldner Testimony at
2 812-13, 853, 891. Indeed, the depreciation study that APS included in the rate case the
3 Company filed on June 1, 2011 specifically addresses the post-retirement ratemaking
4 treatment of Units 1-3.²¹ It is thus premature to judge in this docket that ratemaking
5 treatment, which is precisely what requiring an offset for Units 1-3 capital would be.

6 Even if, for whatever reason, the early retirement of Four Corners Units 1-3 is not
7 addressed in the current rate case, any hypothetical recovery of capital costs associated with
8 Units 1-3 after their retirement should not be used as a reason to refuse to allow APS to
9 defer the capital costs paid to purchase SCE's share of Units 4 and 5. As APS Exhibit 19
10 demonstrates, any benefit from regulatory lag that APS would receive at the end of life for
11 Units 1-3 is nowhere near the magnitude of the loss that APS will suffer if it cannot defer
12 the cost of capital needed to finance the SCE deal. There can be no denying that the net
13 present value of an asset is greater at the beginning of its life than it is at the end. *See*
14 Guldner Rebuttal Testimony (APS Exhibit 15) at 7-8. As APS Exhibit 19 shows, if Units 1-
15 3 remained in a future rate case that used a 2013 test year, the average annual return that
16 APS would earn on those units until the end of their current life (2016) is only \$5 million.
17 Absent a full deferral, APS would absorb financing costs on the SCE deal of more than \$30
18 million per year – over six times what APS would hypothetically “over-recover” on Units
19 1-3.

20 Moreover, APS regularly invests in our system. As a result, the balance of assets on
21 which APS under-recovers because of regulatory lag continues to grow and the mythical
22 balance of under-recovery to over-recovery is not achieved, nor has it ever been achieved
23 by APS in recent decades. Indeed, it is this sort of regulatory “trade-off” that has prevented
24 APS from earning its authorized cost of capital, as determined by the Commission, for at
25 least the last decade if not longer.

26
27
28 ²¹ *See* Docket No. E-01345A-11-0224.

1 **D. *The Sundance Conditions Should Not All Be Applied to This Transaction.***

2 RUCO witness Dr. Fish suggested that if the accounting deferral order is granted, it
3 should be subject to the same conditions that were imposed in the Sundance Order. *See* Fish
4 Testimony (RUCO Exhibit 1) at 32-33. Some of those conditions, specifically those relating
5 to the PSA, have become largely moot over time. Others, such as the treatment of overheads
6 and the netting of PSA savings against the deferral (rather than flowing them through the
7 PSA) are either inappropriate under the circumstances or beyond the scope of the
8 Company's proposal. *See also* Guldner Testimony, Tr. at 865-66. The condition relating to
9 "cost of money" seems to have led to confusion on the part of some as to what the
10 Commission intended and thus at the very least would need to be clarified as being limited
11 to the calculation of a return on deferred amounts and not to the deferral of return on the
12 acquisition cost of Four Corners. The time limit for deferrals (36 months from closing in the
13 case of Sundance), if desired by the Commission, should encompass at least 48 months for
14 the reasons described by APS witness Guldner. *See* Guldner Testimony, Tr. at 864. Finally,
15 the condition relating to costs being "otherwise recovered" eventually morphed into
16 language in the final order that was so ambiguous as to prevent APS from ever deferring
17 any actual Sundance costs. *See* Guldner Testimony, Tr. at 725-26.

18 In point of fact, the characteristics of the two transactions are distinctly different, and
19 conditions that may have been reasonable in Sundance are not needed in this case. The
20 economic climate in place during the Sundance acquisition was such that APS was
21 experiencing a high level of customer growth and increasing sales volumes. The conditions
22 in the Sundance Order assumed that this growth in revenue may partially offset the
23 additional (but much smaller than Four Corners) costs of owning, operating and maintaining
24 the Sundance Units. The opposite is true today. Because of today's economic climate and
25 the continued pursuit of Energy Efficiency targets, the Company's forecast of future sales
26 per customer is not increasing and will likely decrease. There will thus be no growth in per
27 customer revenue margins to offset the costs that the Company proposes to defer related to
28 this acquisition. Put another way, the inability to defer costs in the Four Corners acquisition

1 puts a much more significant financial strain on the Company because per customer sales
2 levels will not be increasing, as they were at the time of the Sundance acquisition. *See* APS
3 Exhibit 15 at 12.

4 Moreover, the magnitude of the Four Corners transaction is over \$100 million larger
5 than the acquisition of Sundance. The acquisition thus has a greater negative financial
6 impact on APS compared to the Sundance purchase. The striking differences between the
7 two transactions require an independent evaluation of the need for and nature of a deferral
8 order. Certain of the conditions present in the Sundance deferral order may have been
9 appropriate for that transaction. For the reasons discussed herein and in the Company's
10 testimony, the deferral order requested by the Company is most appropriate here. *See id.*

11 **E. *Language of the Accounting Order.***

12 In its Direct Testimony, Staff recommended that the accounting order include a
13 provision that allowed APS to "defer, for future consideration of recovery through rates, all
14 non-fuel costs of owning, operating and maintaining the acquired SCE interest in Four
15 Corners Units 4 and 5 net of non-fuel operating and maintenance and property tax savings
16 associated with the closure of Units 1-3." Staff Exhibit 3 at 11-12. Under governing
17 accounting rules, APS may not defer current costs unless the language used in the
18 accounting order authorizing such a deferral makes it sufficiently clear that the costs are
19 "probable of recovery." *See* APS Exhibit 15 at 13. APS is concerned that the clause "for
20 future consideration of recovery through rates" used in Staff's recommendation will not
21 pass this standard. *Id.* Rather, APS proposed that any accounting order authorized in this
22 case use language identical to that used in a prior Commission order, allowing APS "to
23 defer for later recovery the prudent and reasonable non-fuel costs of owning, operating, and
24 maintaining" the acquired SCE interest. *See* Decision No. 67744 (April 7, 2005). This
25 language has already been approved by the Company's outside auditors. Although Staff
26 rejected the Company's suggestion, it offered no principled reason for deviating from past
27 Commission accounting order language in this case, but simply asserted that "we think our
28

1 language is better.” Michlik Testimony, Tr. at 1071. Such reasoning should not prevail,
2 particularly when the potential consequence would be to deprive APS of the ability to
3 benefit from the accounting order that Staff recommends be granted in the first place.

4 **F. *Miscellaneous Issues Related to the Deferral.***

5 During the hearing and in testimony, Staff and RUCO both expressed concerns about
6 the 11% return on equity adopted in Decision No. 71448 (December 30, 2009), which had
7 resulted from a Settlement. *See* Dr. Fish Testimony, Tr. at 621 and Michlik Testimony, Tr.
8 at 1061-62. In its rebuttal testimony, APS agreed that for purposes of the cost deferral, APS
9 would calculate pre-tax capital costs using the embedded cost of debt and cost of equity
10 found reasonable in APS’s pending general rate case, at the ratio of debt and equity also set
11 in that case. *See* Guldner Rebuttal Testimony (APS Exhibit 15) at 11.

12 RUCO also expressed concern that APS was not considering the cost savings from
13 shutting down Four Corners Units 1-3. *See* Fish Testimony (RUCO Exhibit 1) at 29. But
14 APS’s proposal would fully reflect any such savings. For example, the property taxes
15 deferred will be based on actual property taxes that APS pays on the SCE share post-
16 acquisition (less any property tax savings on Units 1-3). Similarly, Operations and
17 Maintenance (“O&M”) costs will be deferred and capitalized only to the extent that APS’s
18 share of overall Four Corners O&M increases as a result of the acquisition of SCE’s
19 interest, thus effectively netting out any reduced O&M attributable to the shutdown of Units
20 1-3. *See* Application at 30.

21 APS will calculate depreciation for the acquired portion of Units 4 and 5 using the
22 Commission-authorized depreciation rates established for APS’s present interest in Unit’s 4
23 and 5. *See id.* These depreciation rates will be established as part of the Company’s pending
24 general rate case and will take into consideration any change in the expected operating lives
25 of all the Four Corners Units.

1 **IV. OTHER GENERAL MISCELLANEOUS ISSUES**

2 **A. *The Commission Should Not Order APS to Issue an RFP for evidentiary***
3 ***purposes.***

4 Having failed to make a colorable legal case for an RFP, the ACPA posits that APS
5 should be required to issue an RFP for the purpose of gathering data about the economic
6 benefits of the Four Corners transaction. Patterson Testimony, Tr. at 953, 955. But the
7 public interest requires precisely the opposite: the Commission should *not* order APS to
8 conduct an RFP unless it knows now that it will not authorize APS to pursue the transaction
9 with SCE. This is true for several reasons:

10 First, from a practical perspective, the evidence in the record is clear that the
11 proposed transaction compares so favorably to a natural gas alternative that a bidder would
12 have to offer its asset well below any recorded price in the history of the industry to beat the
13 Four Corners deal; a RFP thus would unlikely result in any probative evidence. *See* Rose
14 Testimony, Tr. at 173; Berry Testimony, Tr. at 920-921 (in his independent assessment,
15 “[i]t would seem very unlikely that a gas proposal could come in at a lower cost simply
16 because the price of gas would have to be so unrealistically low for such a sustained period
17 to be competitive”). Any such requirement would thus be a matter of form over substance.

18 Second, from the vantage point of a market participant, bidding into an RFP is an
19 expensive, time consuming proposition. *See* Dinkel Testimony, Tr. at 395; Patterson
20 Testimony at 958. To be viewed as a legitimate bidder, a RFP respondent must put together
21 a proposal that is not only cost-competitive, but that APS will view as having a very real
22 potential to go forward, addressing such items as project viability, permitting issues and
23 land rights, OSHA and maintenance recordkeeping and the like. *Id.* at 394-395. Members
24 of the competitive community have indicated that they have spent “hundreds of thousands
25 of dollars in such an effort.” *Id.* at 395. That kind of time and money makes sense when
26 one reasonably believes that a contract may result if the proposal is sufficiently attractive.
27 *See* Dinkel Testimony, Tr. at 389. It does not make sense if the bidder is not confident that
28 a contract will be awarded to one of the bidders when the process concludes.

1 In this case, unless the RFP is ordered on an understanding that the Commission will
2 not proceed with a coal option (notwithstanding the impact to the Navajo people and other
3 non-economic policy issues at play), a bidder would have little comfort that a contract
4 would result – particularly given the evidence in the record about how a combined cycle
5 merchant would have to almost “give away” its asset to compete with the Four Corners
6 deal. For this reason, the general consensus (apart from ACPA), was that such an RFP
7 would not likely result in any bidders. *See, e.g.,* Rose Testimony, Tr. at 173; Berry
8 Testimony, Tr. at 921-22. As Mr. Dinkel explained, “it is not a matter of “issue an RFP,
9 float something on the internet, see who responds, and you find out in six months if anyone
10 is interested. You don’t have a sense of seriousness or legitimacy if you do something too
11 quickly.” Dinkel Testimony, Tr. at 395. Moreover, the fact that APS moved forward with
12 an RFP for what amounts to evidentiary purposes would almost certainly cause the
13 Company to lose credibility with the market – a “Chicken Little” approach that could harm
14 the Company’s relationship with market participants and harm future procurement efforts.
15 Dinkel Testimony, Tr. at 392, 508. Even the ACPA testified that its members would not
16 endorse using the RFP process for the sole purpose of gathering data about the economic
17 viability of the proposed transaction. *See* Patterson Testimony, Tr. at 962.

18 Third, even absent the proposed transaction, APS does not need replacement energy
19 until 2017 at the earliest. *See* Dinkel Testimony, Tr. at 510. Issuing an RFP six years in
20 advance of that need would be “commercially awkward,” requiring bidders to commit their
21 assets five years in advance of when they would be compensated and to speculate about
22 what transmission constraints will exist at the time the resource is needed. *Id.*, Tr. at 399-
23 400, 510. Such a contract would require APS to pay premium prices for asking the
24 counterparty to essentially take its asset off the market. *Id.* Such a deal would also expose
25 APS and its customers to the potential that the seller would overuse the plant between the
26 contract date and the delivery date (generating extra profit for the seller) to the Company’s
27 detriment. *Id.* Such a scenario is akin to entering a contract to buy another person’s car in
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1 five years, requiring the Company to assume the risk that the owner will materially increase
2 the mileage or fail to change the oil before title is passed. *Id.*, Tr. at 400. An RFP for 2017
3 energy needs would not likely make sense until the end of next year, at the earliest
4 (although the Company would need to begin transmission contingency and resource
5 planning immediately). *Id.* at 399. By the time it makes commercial sense for APS to
6 issue a RFP for 2017 resource needs, the opportunity to acquire SCE's share of Units 4 and
7 5 will have passed.

8 Finally, "window shopping" for a gas resource to replace Four Corners generation
9 would be confusing and send the wrong message to the Company's Four Corners co-
10 owners, the fuel supplier with whom APS is currently negotiating for a contract extension
11 on behalf of the project participants, as well as the California regulators and the Federal
12 Energy Regulatory Commission ("FERC"), each of the last two of which must approve the
13 contract for the transaction to move forward. *Id.* at 392. An RFP for a resource to replace
14 Four Corners generation demonstrates a lack of commitment to the contract that APS has
15 executed with SCE, and could well engender either of the regulators to deny the contract's
16 approval. Such a move would be similarly confusing to the Unit 4 and 5 co-owners, who
17 must vote on a capital budget that includes "life extending" investments in Units 4 and 5 as
18 early as August of 2012. *See* APS Exhibit 16. The evidence demonstrated that the RFP
19 process could take as long as 18 months to complete. *See* Dinkel Testimony, Tr. at 396. A
20 co-owner could refuse to vote to approve a capital expenditure for environmental upgrades
21 on the plant if APS appears less than fully committed to the transaction. *Id.* An RFP
22 requirement in this case, when not required by rule or regulation, is the type of artificial
23 procedural hurdle that will cause Four Corners to go the way of Mohave. It is simply not
24 worth the risk.

25 **B. *The Transaction Should Be Authorized to Close Expeditiously***

26 Finally, RUCO witness Dr. Fish recommended that APS be required to delay the
27 closing of its acquisition of SCE's interest in Four Corners "until the earlier of July 1, 2016
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1 or when the EPA mandated capital investment to address nitrogen emission . . . or
2 particulate emissions...is required.” *See* Fish Testimony (RUCO Exhibit 1) at 34-35. This
3 is because the purchase price is reduced for each month closing is delayed after October of
4 2012 to compensate APS for the higher fuel costs it must bear because of such delay and the
5 corresponding benefit to SCE in the form of its lower fuel costs. *See* APS Application at 22
6 and Schiavoni Testimony (APS Exhibit 11) at 6. As one can see, which party actually
7 benefits from any delay in closing depends on fuel and purchased power costs at the time
8 the delay occurs. *See* Rose Testimony, Tr. at 206; Schiavoni Testimony, Tr. at 346 -48; and
9 Fish Testimony, Tr. at 590-91.

10 The agreement between APS and SCE has a scheduled closing date in October of
11 2012 and requires both parties to act in good faith to secure the requisite approvals prior to
12 such date. *See* Schiavoni Testimony (APS Exhibit 11) at Schedule MAS-2, p.34. Either
13 party can walk away from the agreement after December 31, 2012 and, as explained by
14 APS witness Guldner, SCE is somewhat indifferent as between selling the plant to APS or
15 simply running it “to harvest” in 2016 and keeping the intervening fuel savings. *See*
16 Schiavoni Rebuttal Testimony (APS Exhibit 12) at 13 and Guldner Testimony at 816-818.
17 Thus, it would be unwise to risk the tremendous benefits of this transaction on the
18 “assumption” that SCE would extend the closing date to anytime after December 31, 2012.

19 As a practical matter, even the potential for “gaming” of the closing date is a moot
20 point. APS Exhibit 16 indicates that APS must begin making expenditures for the pollution
21 control equipment referenced in Dr. Fish’s testimony by the second half of 2012. *See also*
22 APS Exhibit 12 at 11-12 and 14. During cross-examination, Dr. Fish appeared to
23 acknowledge this point, as well as that made in the prior paragraph relating to fuel price
24 risk, and agreed “it may be beneficial to close on the proposed date.” Fish Testimony, Tr. at
25 592.

26 All the testimony indicates that the proposed transaction with SCE is extremely
27 complicated with many moving parts. The analyses conducted by APS and its independent
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1 consultant, which were reviewed and at least in the case of RUCO witness Dr. Fish,
2 validated by those parties representing consumer interests, show tremendous benefits to
3 APS customers, the environment and the Navajo Nation. APS suggests that now is not the
4 time to take chances that the deal will fall apart for the speculative hope of "sweetening the
5 pot" by a tiny bit more. APS should be permitted to close the transaction as contemplated
6 by the Agreement with SCE.

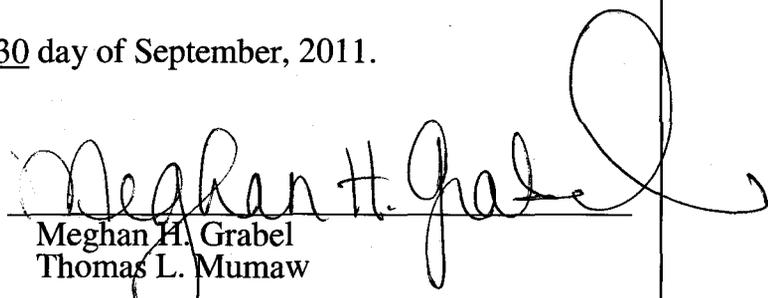
7 **C. Response to the Chief Administrative Law Judge's Request.**

8 Finally, the Chief Administrative Law Judge requested a citation to where the
9 Commission has authorized the recovery of plant decommissioning costs. See Tr. at 806.
10 Although the decommissioning of Four Corners Units 1-3 is not part of the Company's
11 requested deferral, the cost of retiring plant is encompassed in the definition of "net
12 salvage" under A.A.C. R14-2-102. Depreciation expense for ratemaking purposes is
13 calculated on cost less net salvage. Net salvage is usually negative because the scrap or
14 reuse value of an asset seldom exceeds the cost of its removal. The most recent
15 Commission order to mention the concept (which is seldom controversial) was Decision
16 No. 67744 (April 7, 2005) at Attachment A, Paragraph 33 and Exhibit A.

17 **V. CONCLUSION**

18 The Application presents an approach that is good for the environment, good for the
19 Navajo Nation, and good for APS customers. APS respectfully asks that the Commission
20 approve the requests the Company needs to make these benefits happen.

21 RESPECTFULLY SUBMITTED this 30 day of September, 2011.

22
23
24 By: 
25 Meghan H. Grabel
26 Thomas L. Mumaw
27 Attorneys for Arizona Public Service Company

28 ORIGINAL and thirteen (13) copies
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